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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 501

PAUL W. SAMPSELL, as Trustee in Bankruptcy for the Estate of WILBUR J. DOWNEY, also known as W. J. DOWNEY,

Petitioner,

vs.

IMPERIAL PAPER AND COLOR CORPORATION,

Respondent.

PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT THEREOF.

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PAUL W. SAMPSELL, as Trustee in Bankruptcy for the Estate of WILBUR J. DOWNEY, also known as W. J. DOWNEY,

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IMPERIAL PAPER AND COLOR CORPORATION,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

This is a petition for writ of certiorari to the Ninth Circuit Court of Appeals brought before this court under the provisions of Section 24-c of the National Bankruptcy Act (11 USCA, § 47-c and § 240 of Judicial Code, 28 USCA § 347.)

The jurisdiction of the District Court was invoked under the provisions of Section 2, Subd. (2) of the National Bankruptcy Act (11 USCA § 11, Subd. (2).

Jurisdiction of the Circuit Court of Appeals was invoked under the provisions of Section 24-a (11 USCA § 47-a).

The order of the trial court (Referee in Bankruptcy) was entered September 28, 1939. [Tr. p. 35.] The order of the District Court affirming the Referee's order on review was entered on November 17, 1939. [Tr. p. 36.] The order of the Circuit Court of Appeals reversing the order of the District Court was entered on August 12, 1940. [Tr. p. 199.]

A petition for rehearing was filed and was denied on September 7, 1940. [Tr. p. 212.]

The Opinion of the Appellate Court will be found in 114 Fed. (2d) 49, and in the Transcript of Record at page 200.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit, Requiring It to Certify to the Supreme Court of the United States for Its Revision and Determination the Petition for Review in Bankruptcy Taken by Said Respondent Against Petitioner Lately Pending in Said Circuit Court of Appeals.

To the Honorable Charles Evans Hughes, Chief Justice, and Associate Justices of the Supreme Court of the United States:

The petition of Paul W. Sampsell as Trustee in Bankruptcy for the Estate of Wilbur J. Downey, also known as W. J. Downey, a bankrupt, filed by virtue of the provisions of Section 24-c of the National Bankruptcy Act (11 USCA, Sec. 47-c) respectfully represents as follows:

First: That this cause involves a question of far-reaching importance to mercantile and business interests of the country, and upon which the decisions of the Circuit Court of Appeals in the different circuits are at variance, and in conflict with applicable decisions of this Court, thus necessitating an authoritative determination thereupon by this Court.

Second: The questions involved are as follows:

1. May a creditor of a fraudulent transferee of a bankrupt, who participated in the bankrupt's fraud, and who extended credit thereafter to the bankrupt's fraudulent transferee, be permitted, after the fraudulent transfer has been avoided by the trustee, by final decree, and the fraudulent transferee decreed to be nothing but the *alter ego* of the bankrupt, have its claim proved and allowed in full against the bankrupt estate as a claim en-

titled to priority, in the absence of any lien, equitable or otherwise, on the property recovered by the trustee?

2. Is there anything in Section 64 of the Bankruptcy Act of the United States, either of 1898 or 1938, which permits such priority classification as to assets which have become a part of the bankrupt estate?

3. Is a trustee in bankruptcy, in proceedings to avoid transfers made by the bankrupt in actual fraud of his creditors, under the provisions of Section 70-e of the Bankruptcy Act of the United States, together with the Fraudulent Conveyance Act of the State in which the fraudulent transfer occurred, required, before availing himself of the fruits of his recovery, to pay off all the unsecured creditors of the fraudulent transferee, in full, particularly where such creditor or creditors instigated the incorporation of the fraudulent transferee and extended credit to it with full knowledge of the transfer and with notice that existing creditors of the fraudulent transferor might object thereto?

That the proceedings had in the courts below, in brief, were as follows:

Wilbur J. Downey, the bankrupt, was a retail merchant dealing in wallpaper, paints, and other decorative materials, for several years prior to the filing of the petition in bankruptcy. His place of business was at 821 South Flower Street, Los Angeles, California. In July, 1936, he was heavily indebted to one of his creditors, who is a creditor in the bankruptcy proceeding, namely, the Stand-

ard Coated Products Corporation, (formerly Standard Textile Products Company) in the sum of approximately $108,000. His sole asset consisted of his stock in trade in his business, valued at approximately $14,000. [Tr. p. 41.]

Shortly prior to July 1, 1936, the bankrupt Downey went to Glenn Falls, New York and conferred with the president of the Imperial Paper and Color Corporation with regard to taking over its line of merchandise. [Tr. p. 41.] The Imperial Paper and Color Corporation was aware of the enormous indebtedness which Downey owed to the Standard Coated Products Corporation at the time of the conference. The president of the Imperial suggested to Downey that he do one of three things, either form a corporation, go into bankruptcy, or induce the Standard to reduce the indebtedness to what he characterized as "a decent figure." [Tr. p. 41.]

Downey came back to Los Angeles and organized a corporation known as the Downey Wallpaper & Paint Co., which issued shares of stock to himself and to his wife. He took only five shares of the stock himself and the greater portion of it was ultimately issued to his wife. [Tr. pages 42, 43.] Thereafter Downey transferred practically his entire stock in trade to this corporation and took its promissory note payable to himself for the entire purchase price. [Tr. p. 42.]

On June 17, 1936, before the organization of this corporation was completed, Downey's attorney, Frank S. Hutton, wrote to the Imperial Paper and Color Corporation, at whose instigation it was being created, informing it that the corporation was being organized and that Downey was going to sell all of his wallpaper and

paints to his new corporation on six months' terms. He also informed the Imperial people that Downey's proposed plan of reorganization had been "turned down" by the Standard Coated Products Corporation to whom he owed $108,000, and that by the time the Imperial received this letter "We will be functioning full blast as the Downey Wallpaper & Paint Co." [See Trustee's Exhibit No. 1, Tr. pp. 50, 51.]

A week later Mr. Hutton wrote another letter to the Imperial Paper and Color Corporation under date of June 24, 1936. [Trustee's Exhibit No. 2, Tr. p. 52.] In this letter he again reiterated the fact that Downey was going to sell his stock of wallpaper and paint to his new corporation. In addition to that, he informed the Imperial that the Standard Textile people, (a creditor of Downey to the extent of $108,000) were the only ones who could take exception to this kind of deal, but if they did they would be "biting off their nose to spite their face." [Tr. p. 54.]

Downey then filed a Notice under the Bulk Sales Act of California (Civil Code of California, § 3440) announcing his intention to transfer his right, title and interest in the stock in trade of wallpaper and paints to the Downey Wallpaper & Paint Co., on July 28, 1936, at 10 o'clock, in consideration of the sum of *$7500.00,* represented by a promissory note executed by the Downey Wallpaper & Paint Co., payable six months from date. [See Petitioner's Exhibit No. 1, Tr. p. 56.] This transfer occurred on July 28, 1936, but instead of the transaction involving only $7500.00 worth of his stock in trade, as set out in the Notice of Sale of Personal Property, (Petitioner's Exhibit No. 1) Downey actually transferred

to his corporation a stock of wallpaper and paints and other merchandise inventoried at the sum of $14,194.72, and took a promissory note in that amount instead of $7500.00. [See Findings of Fact, Conclusions of Law and Order Quieting Title to Assets dated April 7, 1939, Finding VI, Tr. p. 106.] See also Trustee's Exhibit No. 2 [Tr. pp. 52, 53] in which Mr. Hutton states to the Imperial people that the stock of wallpaper and paint was to be purchased "at inventory."

Payment on the $14,194.72 promissory note was repeatedly extended to his family corporation, voluntarily, by Downey [see Referee's Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Finding XII, Tr. p. 102], the last extension given by him deferring payment of the obligation to June 2, 1939, which was beyond the date of bankruptcy by over six months (Finding XII, *supra*).

The Standard Coated Products Corporation begun pressing its $108,000 claim against the bankrupt on or about June 15, 1938. Two-thirds of the $14,194.72 promissory note from his corporation to himself remained unpaid and then constituted the major part of his assets [Finding XIII, Tr. pp. 111, 112].

For the purpose of further hindering, delaying, or defrauding his creditors, and particularly the Standard people, Downey then proceeded to satisfy a balance of $9000.00 due on said promissory note by causing the corporation to issue to him personally, 99 shares of the capital stock of the corporation in satisfaction of the balance due on said promissory note.

The Permit for the sale of stock in Downey's family corporation, issued by the Corporation Commissioner of

the State of California, expressly provided that the stock was to be issued *only for cash.* In an effort to evade the terms of this Permit and to make it appear that these 99 shares of stock had been issued to him for cash, Downey and his family corporation resorted to the subterfuge of exchanging, or what is commonly called "kiting," two checks between the corporation and the bankrupt, Downey, neither of whom had sufficient funds in their bank account to cover said checks. [Finding XV, Tr. p. 113.]

The day after the issuance to him of the 99 shares of the capital stock in satisfaction of the $9900.00 promissory note held by him, Downey, on July 1, 1938, transferred 49 shares of that stock to his wife, Mildred Downey, and 25 shares to his son, David Downey, entirely without consideration. [See Referee's Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Findings XIII, XIV and XV, Tr. pp. 111 to 113.] Thus the bankrupt effectively completed a fraudulent conveyance of the most lucrative part of his business to a corporation entirely owned by himself, his wife and his son, and which was dominated and controlled entirely in its activities by the bankrupt himself. [See Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Findings XVI and XVII, Tr. pp. 113, 114.]

The Standard Coated Products Corporation instituted an action in the Superior Court of the State of California, in and for the County of Los Angeles. to have Downey's family corporation decreed to be his *alter ego* [see Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Finding V, Tr. pp. 105, 106] which resulted in the bankrupt filing a voluntary petition in bankruptcy on November 18, 1938, in the District Court of the

United States, Southern District of California. Thereafter Paul W. Sampsell was appointed Receiver in Bankruptcy, and as such took possession of the bankrupt's remaining assets. The Downey Wallpaper & Paint Co., which was conducting its business in the same store room and in the same building as the bankrupt, by consent, turned over all its stock in trade, fixtures and other assets to the Receiver and permitted him to operate the business being conducted in its name, pending a hearing and determination of any right, title or interest therein claimed by either the bankrupt or his trustee in bankruptcy to be thereafter elected. Possession of the assets in question passed from the Receiver to the Trustee, thus conferring summary jurisdiction over it on the Referee. [Finding IV, Tr. p. 104.]

After the election of Paul W. Sampsell as Trustee he instituted a summary proceeding before the Referee, against the Downey Wallpaper & Paint Co., a corporation, Wilbur J. Downey the bankrupt, Mildred Downey his wife, and David Downey his son, the sole and only stockholders, officers and directors of said corporation, seeking to have the transfer of July 28, 1936, avoided as fraudulent, to have the bankrupt's family corporation, Downey Wallpaper & Paint Co., decreed to be his *alter ego*, and to quiet title to the stock in trade and fixtures turned over to him, pending hearing, by the Downey Wallpaper & Paint Co. [Tr. p. 77, *et seq.*]

This matter came on for hearing before Referee Hugh L. Dickson on January 12, 1939, and after a number of continuances or adjournments, was concluded on April 7, 1939. [See Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Tr. p. 103.] After a

hearing in which all of the respondents claiming title to the property were represented, the Referee made Findings of Fact, Conclusions of Law and an Order under date of April 7, 1939, decreeing the transfer of $14,194.72 worth of the bankrupt's stock to his family corporation, as having been effected with the actual intent on his part to hinder, delay or defraud his creditors. [See Findings of Fact, Conclusions of Law and Order Quieting Title to Assets, Findings VIII, XIII and XVIII, Tr. pp. 108-111-114.]

The Referee also found that the respondent corporation, Downey Wallpaper & Paint Co., was at all times during its existence nothing but a sham and a cloak devised by Downey and members of his family for the purpose of preserving his assets for the benefit of himself, and for the purpose of hindering, delaying and defrauding his creditors.

Based on those findings, the Referee entered an order decreeing the trustee to be the owner of the assets in question and quieting title thereto against Downey, his wife, his son, and their corporation, and directed that they be marshalled in the estate of the bankrupt and converted into cash by the trustee. [See Order Quieting Title to and Marshalling Assets of Downey Wallpaper & Paint Co., Tr. p. 116.]

This Order was never appealed from, became final, and in conformity therewith the trustee sold the assets so recovered and collected the purchase price thereof.

Thereafter the Imperial Paper and Color Corporation filed a proof of debt in the estate of Wilbur J. Downey, Bankrupt, in the sum of $5,415.95, with interest, assert-

ing the same as a prior claim against the bankrupt estate. [Tr. pp. 7, *et seq.*] The trustee filed objections to the allowance of it as a prior claim on the ground that it did not contain facts sufficient to bring it within Section 64-a or 64-b of the Bankruptcy Act, and prayed that the claim be allowed only as a general unsecured claim. [Tr. pp. 18, 19.] The Imperial Paper and Color Corporation thereupon filed a petition for order to show cause against the trustee, setting up the fact that an order of court had theretofore been entered decreeing the Downey Wallpaper & Paint Co., to be the *alter ego* of the bankrupt [the Order of April 7, 1939; Tr. p. 116] that the trustee had taken possession of the assets and property of the Downey Wallpaper & Paint Co., had sold and disposed of the same, and prayed that the court recognize its claim to an *equitable lien* [Tr. p. 16, par. IV], and requiring payment thereof in full. (Italics ours.)

The petition, together with the trustee's objections to the allowance of the claim as prior, being consolidated for hearing, was duly heard before the Referee on August 29, 1939, and an order entered allowing the claim of the Imperial Paper and Color Corporation as a general unsecured claim, denying priority and refusing to recognize any equitable lien on said fund. [Tr. pp. 31 to 35.]

The Imperial Paper and Color Corporation filed a petition for review which, after hearing, was denied and the order of the Referee confirmed by Honorable George Cosgrave, United States District Judge on November 17, 1939. [Tr. p. 36.] An appeal was thereupon taken to the United States Circuit Court of Appeals for the Ninth Circuit and the order was reversed, with directions to enter an order allowing the claim of the Imperial Paper

and Color Corporation as a prior claim. [See Opinion of the United States Circuit Court of Appeals for the Ninth Circuit, filed August 12, 1940; Tr. p. 200, *et seq.*]

A Petition for Rehearing was denied on September 7, 1940. [Tr. p. 212.]

The judgment of the Circuit Court of Appeals should be reversed by reason of the fact that the opinion is based upon numerous erroneous conceptions of fact, undisputed, which led the Circuit Court of Appeals into the erroneous conclusion that the Standard Coated Products Corporation was in nowise defrauded by the bankrupt's transfer of his $14,194.72 worth of merchandise to his family corporation and that the order of the Referee of April 7, 1939, which had long since become final, was erroneous and should never have been entered, and that the Standard Coated Products Corporation had received the entire consideration for the transfer and was in no position to complain. This erroneous conception of the facts will be discussed in more detail in our brief.

The judgment of the Circuit Court of Appeals should also be reversed for the reason that it has, by judicial construction, created a new class of creditors not provided for in Section 64-a or b of the Bankruptcy Act (11 USCA, Sec. 104-a and b), namely, creditors of a fraudulent transferee of the bankrupt's assets, and has created this new class of prior creditors in conflict with two decisions of the United States Circuit Court of Appeals for the Eighth Circuit. (See *Southern Bell Telephone & Telegraph Co. v. Caldwell*, 67 Fed. (2d) 802, and *United States Fidelity and Guaranty Company v. Sweeney*, 80 Fed. (2d) 235), and would impose an onerous burden on trustees in bankruptcy seeking to avoid fraudulent trans-

fers of bankrupts' assets, or recover their value, under Sections 67-d and e, and Section 70-e of the National Bankruptcy Act. (11 USCA, § 107-d and e, and § 110-e.) This unconscionable burden on the trustee would consist of the necessity of the bankrupt estate paying all of the fraudulent transferees' personal obligations to third parties, in full, before the bankrupt estate could enjoy the fruits of the trustee's recovery. Such a rule would emasculate both of those provisions in many cases and would result in bankrupt estates going to heavy expense in the most difficult kind of litigation, to recover property fraudulently transferred, or its value, only to have the fraudulent transferee's creditors later step into the Bankruptcy Court and leave with all of the proceeds recovered, and with their claims paid in full.

The decision of the Circuit Court of Appeals for the Ninth Circuit, in addition to being contrary to the two decisions of the Eighth Circuit hereinabove cited, runs absolutely counter to the decisions of this court relating to equality of distribution of bankrupt assets, namely, *Moore v. Bay*, 284 U. S. 4, and *Buffum v. Barceloux*, 289 U. S. 227.

Your petitioner annexes hereto his brief in support of his petition.

Wherefore, your petitioner prays that a writ of certiorari may be issued out of and under the seal of this court, directed to the United States Circuit Court of Appeals for the Ninth Circuit, commanding said court to cer-

tify and send to this court, on a day certain to be therein designated, a full and complete transcript of the record in all proceedings in said Circuit Court of Appeals in this case therein entitled Imperial Paper and Color Corporation, Appellant, vs. Paul W. Sampsell, Trustee of Wilbur J. Downey, also known as W. J. Downey, Bankrupt, Appellee, on petition of Imperial Paper and Color Corporation for review, No. 9422, to the end that said case may be reviewed and determined by this court, as provided by law; and that the judgment of the said Circuit Court of Appeals in said case may be reversed by this Honorable Court.

And that petitioner may have such other and further relief as may seem meet and proper.

And your petitioner will ever pray.

PAUL W. SAMPSELL,
As Trustee in Bankruptcy for the Estate of Wilbur J. Downey, Bankrupt,
Petitioner.

Thomas S. Tobin,
817 Board of Trade Bldg.,
Los Angeles, California.

Frank C. Weller,
817 Board of Trade Bldg.,
Los Angeles, California.

Of Counsel.

United States of America, Southern District of California,
Central Division, County of Los Angeles—ss.

Paul W. Sampsell, being by me first duly sworn, deposes and says: That he is the Trustee in Bankruptcy and Petitioner in the above entitled action; that he has read the foregoing Petition for Writ of Certiorari and knows the contents thereof; that the same is true of his own knowledge except as to the matters which are therein stated upon his information or belief, and as to those matters that he believes it to be true.

PAUL W. SAMPSELL.

Subscribed and sworn to before me this 23rd day of November, 1940.

BESS A. ALDRICH,
Notary Public in and for the County of Los Angeles, State of California.

Certificate of Counsel.

I, Thomas S. Tobin, a member of the bar of this court, hereby certify that I believe the foregoing Petition for Writ of Certiorari is well founded and meritorious, and is not interposed for the purpose of delay.

THOMAS S. TOBIN.

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Petitioner,

vs.

IMPERIAL PAPER AND COLOR CORPORATION,

Respondent.

BRIEF IN SUPPORT OF PETITION.

The opinion of the Circuit Court of Appeals in the case at bar is in clear conflict with two decisions of the Circuit Court of Appeals for the Eighth Circuit dealing with equitable priorities, namely, *Southern Bell Telephone & Telegraph Company v. Caldwell,* 67 Fed. (2d) 802, 24 Am. B. R. (N. S.) 1, and *United States Fidelity and Guaranty Company v. Sweeney,* 80 Fed. (2d) 235, 29 Am. B. R. (N. S.) 705.

It is also in conflict with the rule laid down by the Circuit Court of Appeals for the Eighth Circuit in *Burton Coal Co. v. Franklin Coal Co.,* 67 Fed. (2d) 796, limiting the extent of the equity jurisdiction to that conferred upon it by the provisions of the Bankruptcy Act as reasonably interpreted.

It is also in clear conflict with the decisions of this court construing Section 65 of the Bankruptcy Act; *Moore v. Bay*, 284 U. S. 4; *Buffum v. Barceloux Co.*, 289 U. S. 227.

We first refer the court to the sole priority section of the Bankruptcy Act. Section 64-b of the Act specifically sets up debts which are to have priority in advance of the payment of dividends to creditors, in the following order:

1. The actual and necessary costs and expenses of preserving the estate subsequent to the filing of the petition, the filing fees paid by creditors in involuntary proceedings, reimbursement of creditors' expense involved in recovering fraudulently transferred property, costs and expenses of administration, including opposition to the bankrupt's discharge, witness fees and attorneys' fees.
2. Wage claims not to exceed $600.00 earned within three months before the date of the filing of the petition.
3. Successful resistance to confirmation of a composition, or revocation thereof.
4. Taxes.
5. Debts owing to any person who by the laws of the United States is entitled to priority, and landlords prior rent, with certain restrictions allowed by state law.

Claimants who have liens against the bankrupt's property which are valid are protected in them under the provisions of Section 67-b of the Bankruptcy Act (11 USCA, Sec. 107-b). After the disposition of claims of creditors

holding liens on the bankrupt's property and those accorded priority by statute, all other creditors are relegated to Section 65-a (11 USCA, Sec. 105-a) which provides:

> "Dividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured."

And Section 65-e (11 USCA, Sec. 105-e) which provides:

> "A claimant shall not be entitled to collect from a bankrupt estate any greater amount than shall accrue pursuant to the provisions of this Act."

Upon the filing of the petition in bankruptcy by Wilbur J. Downey the trustee was vested, by operation of law, with the title of the bankrupt to,

(4) Property transferred by him in fraud of his creditors, and

(5) Property, including rights of action which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded or sequestered."

See Bankruptcy Act, Section 70-a (11 USCA, Sec. 110A).

The fraudulent transfer of Downey's assets was avoided under the provisions of Section 70-e of the Bankruptcy Act (11 USCA, Sec. 110-e), which reads as follows:

> "All property of the debtor affected by any such (fraudulent) transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such trans-

fer or obligation shall be avoided by the trustee for the benefit of the estate. The trustee shall reclaim and recover such property or *collect its value* from and avoid such transfer or obligation against whomever may hold or have received it, except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision (e) is valid under applicable Federal or State laws." (Parenthetical matter and italics ours.)

In avoiding this fraudulent transfer the trustee proceeded against the only proper parties thereto, the fraudulent transferee, Downey Wallpaper & Paint Co., its stockholders, officers and directors, although the latter may not have been necessary parties. Its creditors were in nowise proper parties, particularly in view of the fact that none of them had a lien on the property sought to be recovered by the trustee.

Upon recovery of the stock in trade in possession of the fraudulent transferee and the conversion of the same into cash, as constituting the value of the property fraudulently transferred, the fund in the hands of the trustee then became available for dividends of an equal per centum to be paid to all creditors of the bankrupt who had proved their claims.

Bankruptcy Act, Section 65-a;
Moore v. Bay, 284 U. S. 4, and cases there cited;
Buffum v. Barceloux Co., 289 U. S. 227.

We have examined a number of cases in various jurisdictions holding that a fraudulent transferee or a person participating in the perpetration of a fraudulent transfer, if a creditor, is to be permitted, after the transfer has

been avoided by the trustee, to share on an equal basis with other creditors in the distribution of dividends, but always on an *equal basis.* (Italics ours.)

Buffum v. Barceloux Co., supra;

Barks v. Kleyne, 15 Fed. (2d) 153, 8 Am. B. R. (N. S.) 659;

Keppel v. Tiffin Savings Bank, 197 U. S. 356, 13 Am. B. R. 552 (involving a fraudulent preference).

But nowhere have we found an authority which relegates a party instigating or participating in a fraudulent transfer, into the category of a priority creditor who must be *paid in full* before the general creditors may share in the fruits of the trustee's recovery, as is the case here.

It stands undisputed that this dummy corporation was organized originally at the instigation of the Imperial Paper and Color Corporation, through its president, in a conference with Downey at Glenn Falls, New York in April, 1936. [Tr. p. 41.]

It is undisputed that the Imperial Paper and Color Corporation knew that this corporation was being organized as early as June 17, 1936, and that Downey's stock in trade was to be sold to it on six months' credit, and that the object of the transaction was to *protect this new corporation from being involved with the financial status existing between Downey and the Standard Textile Company.* There is no question but that the Imperial people knew that Downey's proposed plan of reorganization had been turned down by the Standard Textile Company and that Downey intended, by the time the letter was received, to be going ahead "functioning full blast as the Downey

Wallpaper & Paint Co." [See Letter of Frank S. Hutton dated June 17, 1936, Trustee's Exhibit No. 1, Tr. pp. 50, 51.]

There is no dispute that the Imperial Paper and Color Corporation was again warned a week later that the Standard Textile might seriously object to the transaction, but that if it did it would be "biting off its nose to spite its face." [See Trustee's Exhibit No. 2, Tr. pp. 52 to 54.]

With full knowledge of the consummation of the fraud which had been instigated by it, the respondent here sold merchandise to Downey's dummy corporation, on open account or evidenced by promissory notes, and at the date of bankruptcy had no lien whatsoever on any part of its stock in trade or other assets. Nevertheless, the Circuit Court of Appeals has recognized an equitable lien in favor of the Imperial Paper and Color Corporation upon the assets of Downey's dummy corporation, notwithstanding the fact that such a lien on personal property in California is absolutely impossible. (See 16 Cal. Juris Chapter on Liens, page 310, Section 12, and Civil Code of California, Section 3440.)

Section 3440 of the Civil Code of California, in so far as material here, reads as follows:

> "Every transfer of personal property * * * and every lien thereon, other than a mortgage, when allowed by law, * * * is conclusively presumed if made by a person having at the time the possession or control of the property, and not accompanied by an immediate delivery and followed by an actual and

continued change of possession of the things transferred, to be fraudulent, and therefore void against those who are his creditors while he remains in possession, and the successors in interest of such creditor, and against any person on whom his estate devolves in trust for the benefit of others than himself."

The trustee being vested by operation of law as of the date of the filing of the petition, with the title of the bankrupt to this property, as being property transferred by him in fraud of his creditors (Bankruptcy Act, Sec. 70-a), and likewise being a creditor of the fraudulent transferee, Downey Wallpaper & Paint Co. *for the value of the property,* and there being no contention that the Imperial Paper and Color Corporation was in possession of this stock in trade at any time, it was absolutely impossible for it to have an equitable lien thereon. It would therefore be necessary for the Imperial Paper and Color Corporation, being unsecured, to file a general unsecured claim against the bankrupt estate under the provisions of Section 63-a of the Bankruptcy Act, or demonstrate, if it desired priority in payment, that it was within one of the classes specified as priority creditors under Section 64-a of the Bankruptcy Act.

Its other remedy was, within four months after the trustee had avoided the fraudulent transfer, to have filed an involuntary petition in bankruptcy against the Downey Wallpaper & Paint Co., alleging that the trustee in bankruptcy of Wilbur J. Downey had obtained a preference. It is set forth in paragraph V of the Imperial Paper and Color Corporation's petition for order to show cause that it was the only existing unpaid creditor of the Downey Wallpaper & Paint Co. [Tr. p. 17.] Thus it

could have filed a one creditor involuntary petition against Downey's family corporation. (Bankruptcy Act, Sec. 59-d, 11 USCA, Sec. 95-d.)

Upon adjudication of the Downey Wallpaper & Paint Co., as a bankrupt, the Imperial Paper and Color Corporation would have then been a creditor in the sum of $5,415.95 and the trustee in bankruptcy of Downey a creditor in the sum of $14,194.72 and the assets of the family corporation would have been shared *pro rata*. As it is, the judgment of the Circuit Court of Appeals requires the Imperial to be paid in full.

This requirement of payment in full creates a new priority of claims against the bankrupt estate which are not included in Section 64-a of the Bankruptcy Act, and which requirement is in clear conflict with two decisions of the United States Circuit Court of Appeals for the Eighth Circuit, *Southern Bell Telephone & Telegraph Co. v. Caldwell,* 67 Fed. (2d) 802, and *United States Fidelity and Guaranty Co. v. Sweeney,* 80 Fed. (2d) 235.

It is in clear conflict with the holding of this Court in the case of *Moore v. Bay,* 284 U. S. 4, relating to equality of distribution, which principle was reiterated by this Court in *Buffum v. Barceloux,* 289 U. S. 227.

In the last named case a fraudulent transferee's claim had been subordinated to the claims of other creditors. Mr. Justice Cardozo closed the opinion of the court with the following language:

> "The defendant may participate on the same basis with other creditors in the distribution of the assets. The decree of the District Court is erroneous in so far as the claim of the defendant is postponed to those of others. Moore v. Bay, *supra.*".

Erroneous Conceptions of Fact in Opinion.

At the time of the argument of this case before the Circuit Court of Appeals, the Findings of Fact, Conclusions of Law and Order Quieting Title to Assets entered by the Referee on April 7, 1939, which had been a part of the record on review before the District Court but through error had not been printed in the transcript of record sent to the Circuit Court of Appeals, was by order of the Circuit Court of Appeals sent up and made a part of the record and is a part of the record here. Thereafter while the cause was under submission the Circuit Court of Appeals ordered additional portions of the Downey bankruptcy record consisting of Downey's Schedules and the Proofs of Debt of both the Imperial Paper and Color Corporation and the Standard Coated Products Corporation to be certified up. [Tr. p. 118.]

We raise no objection to this procedure, as it was clearly the desire of the Circuit Court of Appeals to get all the facts possible before it. However, unfortunately, there was no argument subsequent to the certifying up of these additional portions of the record and the Circuit Court of Appeals, without the benefit of oral argument explanatory of certain facts, fell into error as to the established and uncontradicted facts, which error is apparent in its opinion. We wish to point out a number of these erroneous statements of fact:

1. The Opinion says [Tr. pp. 203, 204]:

> "We assume—there being no evidence to the contrary—that the shares were issued and paid for as the bankrupt's attorney had told appellant they would be." [Opinion Circuit Court of Appeals, Tr. pp. 203-04.]

The evidence [Tr. p. 59]:

> The Referee: How much cash, if any, was paid when you transferred your $14,000 worth of assets to this new corporation?
>
> The Witness: We subscribed $500.00 for the stock.
>
> The Referee: Was that actually paid in money?
>
> The Witness: Yes, in money, Your Honor.

The Referee's findings in the Order Avoiding the Fraudulent Transfer from Downey to the Downey Wallpaper & Paint Co.

Finding XIII [Tr. p. 111]:

> "That on or about the 15th day of June, 1938, the Standard Coated Products Corporation began pressing said bankrupt, Wilbur J. Downey, for payment of the obligation owing to it by said bankrupt, and thereafter, on June 30, 1938, at a time when said Standard Coated Products Corporation was vigorously demanding payment of said obligation, said bankrupt, notwithstanding the fact that the obligation held by him against the Downey Wallpaper & Paint Co. constituted the larger part of his assets, and while hopelessly insolvent, for the purpose of hindering, delaying, or defrauding his creditors, and particularly the Standard Coated Products Corporation, without notice to it, caused the Downey Wallpaper & Paint Co. to issue to him 99 shares of the capital stock of said Downey Wallpaper & Paint Co., in satisfaction in full of said obligation; that at the time of the issuance of said shares of stock to the said bankrupt, there was outstanding a permit from the Corporation Commissioner of the State of California authorizing the issuance of the shares of the capital stock of the Downey Wallpaper & Paint Co.

only for cash; that said Permit was the only Permit to issue said shares in existence at said time; that notwithstanding the plain terms and provisions of said Permit, said Downey Wallpaper & Paint Co., and its officers and directors, proceeded to and did issue to the said Wilbur J. Downey on June 30, 1938, 99 shares of the capital stock of said corporation, and that on the following day, July 1, 1938, said bankrupt caused 49 shares of said stock to be transferred to the respondent, Mildred Downey, and 25 shares of said stock to his son, David Downey, entirely without consideration to him."

2. The Opinion says [Tr, p. 204]:

"Thus we assume that 50 shares were issued to and paid for by each of the incorporators. The bankrupt apparently did not retain all of his 50 shares."

The Referee's Finding XIII [Tr. p. 111] hereinbefore set out expressly found that 99 shares of the capital stock were issued to Downey on June 30, 1938, and transferred by him, to a great extent, to his wife and son the following day, July 1, 1938, without consideration, and that 50 shares of stock were not issued to and paid for by each of the incorporators. The testimony of the witness Downey in this proceeding [Tr. p. 59] expressly states that the incorporators subscribed $500.00 for the stock which, at par value of $100.00 per share would account for only five shares of stock instead of fifty, as found by the Circuit Court of Appeals.

In Finding XIV the Referee found [Tr. p. 112]:

"The Referee finds that said issuance of said 99 shares of stock, as described in the preceding finding, in satisfaction of the obligation owing to the bank-

rupt by said Downey Wallpaper & Paint Co., was brought about by the bankrupt and the other respondents herein for the purpose of preventing the Standard Coated Products Corporation from levying writs of attachment, garnishment, or execution upon said obligation in the enforcement of its claim against the bankrupt, Wilbur J. Downey, and that the further transfer by the bankrupt, Wilbur J. Downey, of the 25 shares of the capital stock so issued to his son, David Downey, and the 49 shares to his wife, Mildred Downey, was accomplished for the purpose of further placing beyond the reach of said Standard Coated Products Corporation any beneficial interest in said obligation owing said bankrupt by the Downey Wallpaper & Paint Co., of which it might avail itself in the collection of its indebtedness owing to it by said bankrupt."

In Finding XV [Tr. p. 113] the Referee found:

"That in accomplishing the issuance of said 99 shares of stock to said respondents no cash whatsoever was paid therefor, but a fictitious cash consideration was created by means of an exchange of checks between the bankrupt, Wilbur J. Downey, and the Downey Wallpaper & Paint Co., which exchange of checks occurred simultaneously and at a time when neither of the makers of said checks had sufficient funds in their respective bank accounts to have paid said checks, or either of them, except for the exchange thereof."

3. The Opinion says [Tr. p. 204]:

"It is clear, however, that the bankrupt never owned more than one-third of the corporation's stock, and at the time of the filing of the petition, may have owned as little as one-thirtieth."

The Referee's Finding XIII, in connection with the Order Avoiding the Fraudulent Transfer, finds that 99 additional shares of the capital stock of the corporation were issued by it to the bankrupt on June 30, 1938, and that on July 1, 1938, the bankrupt transferred 49 shares of it to his wife and 25 shares to his son, entirely without consideration, and in paragraphs XIII and XIV he finds that the sole consideration for the issuance of these additional 99 shares to Downey was the satisfaction of the balance due on the promissory note given by the corporation to Downey, and that the subsequent transfer of these shares to Downey's wife and son, without consideration, was made with the intent to further place the beneficial interest therein beyond the reach of the bankrupt's creditors. The reason that the bankrupt, at the time of the filing of the petition "may have owned as little as 1/30th" of the capital stock of the corporation was that he had theretofore fraudulently conveyed all except the few shares listed in his schedules, to his wife and son.

4. The Opinion says [Tr. p. 204]:

> "On July 21, 1936, the bankrupt * * * recorded in the office of the County Recorder a notice of the intended sale of his then existing stock of wallpaper and paints to the corporation. The notice stated that the sale would be made on July 28, 1936, for a consideration of $7500.00, represented by the corporation's promissory note payable six months from that date. *The sale was made pursuant to the notice.*" (Italics ours.)

The Evidence [Tr. p. 53]:

Trustee's Exhibit No. 2, the letter written by Major Hutton, the bankrupt's attorney, to the petitioner, Imperial

Paper and Color Corporation [Tr. p. 53], expressly states that:

> "The stock of wallpaper and paint will be purchased by the new company from W. J. Downey *at inventory.*" (Italics ours.)

It is therefore clear that the Circuit Court of Appeals was under a misconception as to the amount of the promissory note taken by Downey from the corporation, which actually was in the sum of $14,194.72 instead of $7500.00 as the Circuit Court of Appeals assumed.

The vice of this erroneous conception will be apparent in the sixth error of fact which we shall presently point out.

5. The Opinion says [Tr. p. 205]:

> "At the time of the sale by the bankrupt to the corporation—July 28, 1936—Standard was the bankrupt's only creditor. At that time the contract of April 1, 1933, between Standard and the bankrupt was still in force. Thereby the bankrupt was required to, *and presumably he did,* pay over to Standard or its assignee, for application on his notes, all money realized from the sale made by him to the corporation on July 28, 1936." (Italics ours.)

The Evidence [Tr. p. 111]:

It was definitely established at the trial of the fraudulent conveyance issue that Downey did not pay over to the Standard or its assignee for application on its note all the money realized from the sale made by him to the corporation on July 28, 1936, but, on the contrary, utilized a $9900.00 unpaid balance on the note given him by his corporation to "purchase" 99 shares of the capital stock of

the corporation to be issued directly to him. The day after these shares were issued to him he transferred most of this newly issued stock to his wife and son. Thus instead of the bankrupt paying over to the Standard the purchase price of this stock in trade he suddenly utilized almost two-thirds of the unpaid balance to cause stock in the corporation to be issued to himself and promptly transferred it to his wife and son, thus keeping it in the family. [See Referee's Findings XIII and XIV, Tr. pp. 111, 112.]

When the Circuit Court of Appeals examined the Schedules filed by Downey in his bankruptcy proceeding, certified up as an additional part of the record, naturally it did not find scheduled any balance due on this note for $14,194.72, by reason of the fact that on June 30, 1938 [Referee's Finding XIII, Tr. p. 112], Downey had cancelled the note in exchange for the 99 shares of stock issued to him. Neither did the Circuit Court of Appeals find in Downey's Schedules a listing of the 99 shares of stock, as the bankrupt had transferred 74 shares of it to his wife and son on July 1, 1938, entirely without consideration. [See Referee's Findings XIII and XIV, Tr. p. 112.]

The Circuit Court of Appeals was therefore led to the conclusion that the Standard Coated Products Corporation had received the entire purchase price of this stock in trade and was not defrauded; whereas, in truth and in fact only $5,000 was ever paid on this promissory note, outside of the issuance of the 99 shares of stock to Downey.

See Transcript of Testimony of Wilbur J. Downey, page 42, as follows:

Q. You took a promissory note?
A. Yes.
Q. And that was never paid?
A. $5,000 was paid, in cash.

6. The Opinion says [Tr. p. 205]:

"The bankrupt received in consideration of the sale, the corporation's note for *$7500.00* of which it is conceded $5,000 was paid. The bankrupt testified before the Referee that the balance ($2500.00) was not paid." (Italics ours.)

The Evidence [Tr. p. 111]:

It is in this statement that the vice of the misconception of the Circuit Court of Appeals as to the amount of the promissory note taken by Downey, is evident. The Court overlooked the fact that the amount of the promissory note was $14,194.72 [Tr. p. 107] and that with a $5,000 payment having been made in cash (according to Downey's testimony) there was actually a balance due, without interest, amounting to $9,192.72, instead of only $2500.00 as the Circuit Court of Appeals assumed, for which 99 shares of capital stock were issued to Downey on June 30, 1938.

The bankrupt testified in this proceeding [Tr. p. 42]:

Mr. Tobin: Q. After you organized the corporation you transferred all of your stock—all of your own stock to it, did you not?
A. No, a great part of it, yes.
Q. $14,000 worth?
A. Yes.

Q. And you did it on credit?
A. Yes.
Q. You took a promissory note?
A. Yes.
Q. And that was never paid?
A. $5,000 was paid, in cash.

Further along in his testimony [Tr. p. 59] Downey testified as follows:

> The Referee: How much did you get in payment at the time of the transfer?
>
> The Witness: Nothing, Your Honor, the corporation wrote a note, subsequently, we paid $5,000 cash against that note.

In Finding XIII [Tr. pp. 111, 112] the Referee found that the bankrupt caused the Downey Wallpaper & Paint Co., to issue to him 99 more shares of the capital stock of the Downey Wallpaper & Paint Co., in satisfaction in full of said obligation, which was thereafter, the next day, transferred to his wife and son without consideration. [Tr. p. 112.] Thus, by no stretch of the imagination could the Standard Coated Products have received the balance of the purchase price of said stock in trade.

Yet,

7. The Opinion says [Tr. pp. 205, 206]:

> "Therefore, we think it may reasonably be inferred that the corporation's note for *$7500.00 was fully paid, and that Standard or its assignee received the full amount thereof.*" (Italics ours.)

Without repetition, we believe that this erroneous conception of fact has been fully covered in the preceding discussions.

8. The Opinion says [Tr. p. 206]:

> "Standard and its assignee were fully advised of the sale by the bankrupt to the corporation. Neither of them objected or complained."

The evidence:

Downey testified differently [Tr. pp. 45, 46] as follows:

> Q. You say there was no idea in your mind at that time to form a new corporation?
>
> A. The meaning of that is, I had no idea of forming a corporation when I was in Glenn Falls.
>
> Q. And the suggestion came from the Imperial Paper and Color Corporation? (Mr. McBride, President.) (Parenthetical matter ours.)
>
> A. Yes.
>
> Q. Well, we are only interested in the corporation itself. Read the question. (Question read.)
>
> Q. The question is this: Did you tell him that you would do that, if you were unable to get the indebtedness reduced?
>
> A. Not at that time, no.
>
> Q. When did you do that?
>
> A. By correspondence, *after I received this refusal on the part of the Standard Company.* (Italics ours.)

The objection of the Standard Coated Products Corporation to this interesting arrangement is likewise evidenced by the language used in Trustee's Exhibit No. 1, Attorney Frank S. Hutton's letter to the Imperial Paper

and Color Corporation dated June 17, 1936, in which he states [Tr. p. 51]:

> "Mr. Downey's plan of reorganization was turned down by the Standard."

And his statement in Trustee's Exhibit No. 2 [Tr. p. 54] that:

> "The only entity that could possibly take exception to this new transaction is the Standard Company, but if any exception is taken to it, it simply means that they will be biting off their nose to spite their face, and the psychology is all in favor of a successful conclusion."

At page 58 of the Transcript Downey testified, in response to his counsel's questions, as follows:

> Q. And was anything done by any one on your behalf to conceal the fact that you intended to form the corporation?
>
> A. No, not at all. I wrote to the Standard Company very frankly and told them. * * *
>
> Q. In other words, you wrote a letter to the Standard Textile Company informing them of your plan?
>
> A. Yes.
>
> Q. That was before the corporation was formed?
>
> A. *After it was formed, Mr. Casey.* (Italics ours.)

At page 63 of the Transcript, he testified:

> Q. And isn't it a fact that at the time you advised the Standard Company of the formation of this corporation, that they refused to accept this proposition?
>
> A. *Yes, because of their own internal trouble.* (Italics ours.)

In the proceeding to avoid the fraudulent transfer the Referee found in Finding VI [Tr. pp. 106, 107]:

> "* * * That without the knowledge or consent of said Standard Coated Products Corporation, a corporation, and while heavily indebted to it, as aforesaid, said bankrupt, Wilbur J. Downey, after causing to be organized under the laws of the State of California said respondent Downey Wallpaper & Paint Co., caused all of the capital stock therein to be issued to himself, his wife, the respondent Mildred Downey, and to his son, respondent David Downey, and caused himself, his wife Mildred Downey and his son David Downey to be elected as directors of said Downey Wallpaper & Paint Co., and thereafter to be elected president, vice-president and secretary-treasurer, respectively."

And four days later he made the deal to transfer his assets to it. [Finding VII, Tr. p. 107.]

9. The Opinion says [Tr. p. 206]:

> "Instead, with full knowledge of the sale, Standard and its assignee extended further credit to the bankrupt to the amout of more than $5,000."

This statement is apparently based upon the fact that proofs of debt filed by the Standard in the Downey bankruptcy proceeding indicate that merchandise had been sold to him on credit or on consignment, subsequent to the sale by the bankrupt of his stock in trade on July 28, 1936. Even though this might be true there is nothing in the

record that indicates *when* Downey conveyed the information to the Standard that he had formed this corporation and that he had transferred a $14,000 stock to it.

It will be noted that the Contract, Exhibit "A", between Downey and the Standard Textile Company which was attached to the proof of debt for $104,000, which is found in the Transcript at page 179, and which Contract was relied upon by the Circuit Court of Appeals in drawing the inferences that because it provided for payment to the Standard of the proceeds of Downey's sales of stock, that that was usually done, expressly provides [Tr. p. 190]:

> "Party of the first part does hereby agree to provide party of the second part with a *consigned* stock of its products which shall be sufficient to enable second party to properly carry on his business as a Distributor for first party, party of the first part to be the sole judge as to the amount of such consigned stock which shall be sufficient to carry on said business in accordance herewith." (Italics ours.)

We may, therefore, well assume that the amount of "credit" which the Circuit Court of Appeals found was extended to the bankrupt in an amount of more than $5,000, consisted of sales of merchandise on consignment, which had not been accounted for.

Furthermore, in the Findings in connection with the Order Avoiding the Fraudulent Transfer, the Referee found [Finding VI, Tr. p. 106] that, contrary to the

Standard not objecting or complaining of the transfer, there was at the date of the adjudication of the bankrupt as a bankrupt, in the Superior Court of the State of California, in and for the County of Los Angeles, a suit pending in the nature of a Creditors' Bill brought by the Standard Coated Products Corporation for the purpose of determining the question of *alter ego* existing between the Downey Wallpaper & Paint Co., and the bankrupt. This suit was naturally halted by reason of the bankruptcy of Downey, and the corporation having turned over its assets to the receiver and trustee in bankruptcy of Downey's estate, by stipulation. [See Finding IV, Tr. p. 105.]

10. The Opinion says [Tr. p. 209]:

> "In the case at bar, Appellee did not allege or ask the Referee to hold that the corporation was the bankrupt's *alter ego,* nor did the facts warrant such a holding. For the bankrupt did not own all or even a majority of the corporation's stock. The evidence is that he owned less than one-fifth of it."

The inaccuracy of this statement is evident on examination of the Referee's Finding of Fact XIII [Tr. pp. 111, 112] that 99 additional shares of the capital stock of the corporation were issued by it to the bankrupt on June 30, 1938, and on the next day 49 shares were transferred by him to his wife and 25 shares to his son, entirely without consideration to him.

If this last fraudulent transfer had not taken place the bankrupt, at the date of bankruptcy, would have owned

two-thirds or more of the capital stock and the balance would have been held by his wife and son. In either way the rights of the Standard Coated Products Corporation were placed entirely at the mercy of the bankrupt Downey and his immediate family. In fact, Downey admitted [Tr. p. 42] that he still owed the greater part of the indebtedness to the Standard Coated Products Corporation, and that after the transfer of his $14,000 stock in trade to his family corporation he had nothing but five shares of its stock in his own name out of which the Standard Coated Products could collect that claim. [Tr. p. 42.]

It is also significant that the merchandise taken over by the trustee from the Downey Wallpaper & Paint Co., did not consist entirely of wallpaper purchased from the Imperial Paper and Color Corporation. A part of it was paint which had been bought from a dozen different concerns. [See redirect examination of Downey, Tr. pp. 61, 62.]

No effort was made on the part of the Imperial Paper and Color Corporation to establish an equitable lien on the stock in trade of the Downey Wallpaper & Paint Co., or to show what portion of its stock was wallpaper and what portion was paint, yet the trustee is required by the order of the Circuit Court of Appeals to pay the sum of $5,415.95 principal out of the proceeds derived by him from the sale of the Downey Wallpaper & Paint Co., stock, which consisted in part of paints purchased from a dozen different companies and which had been paid for.

Trustee's Rights Under State Law and Under the Bankruptcy Act.

At the time of the fraudulent transfer by the bankrupt of this $14,194.72 worth of merchandise to his family corporation on July 28, 1936, and at the date of his adjudication in bankruptcy on November 19, 1938, and at the date of the hearing of the proceeding before the Referee to avoid such fraudulent conveyance, Section 3439 of the Civil Code of California, the Fraudulent Conveyance Act (Civil Code, Division 4, art 2, Title 11, Section 3439) read as follows:

> "Every transfer of property or charge thereon made, every obligation incurred, and every judicial proceeding taken, with intent to delay or defraud any creditor or other person of his demands, is void *against all creditors of the debtor,* and their successors in interest, and against any person upon whom the estate of the debtor devolves in trust for the benefit of others than the debtor." (Italics ours.)

The Referee, in his order avoiding this fraudulent conveyance, found not once, but in several places that the conveyance was actually made by Downey to the Downey Wallpaper & Paint Co. with the actual intent on his part to hinder, delay, or defraud the Standard Coated Products Corporation [Finding VI, Tr. p. 106; Finding XIV, Tr. p. 113], and in addition to his intent to defraud the Standard Coated Products Corporation the Referee also found that the corporation was devised as a sham and a cloak for the purpose of preserving and conserving his assets for the benefit of himself and the immediate members of his family for the purpose of hindering, delaying and defrauding "his creditors." [Finding XVIII, Tr. p. 114.]

The Circuit Court of Appeals has apparently overlooked the fact that there were other creditors of the bankrupt who have provable claims on file and as to whom this transfer operated as a fraud. The records show the claims of Blake, Moffitt & Towne, $25.89 [Tr. p. 143]; Price, Waterhouse & Co., $450.00 [Tr. p. 139]; Dun & Bradstreet, Inc., $59.33 [Tr. p. 157]; Howard Automobile Company of Los Angeles, $41.53 [Tr. p. 170], together with various tax claims against the bankrupt.

Under the provisions of Section 3439 this transfer was void as against *all* creditors of the debtor, and not merely against those who existed at the date of the transfer.

Bush & Mallett v. Helbing, 134 Cal. 676;
Horn v. The Volcano Water Co., 13 Cal. 62, at page 72.

And the trustee or the creditors entitled to attack a fraudulent conveyance are not restricted to the sometimes empty remedy of attempting to set it aside. Creditors and the trustee are permitted under California law, if the property has been sold or disposed of, to recover the value of it from the fraudulent transferee as a trustee *ex maleficio*.

The Circuit Court of Appeals in its opinion points out [Tr. pp. 207, 208]:

> "We do not think the evidence shows that the sale by the bankrupt to the corporation was made with intent to hinder, delay, or defraud any creditor of the bankrupt. But even if it did, that would not justify the referee's order, for the sale did not involve any property dealt with or affected by the referee's order. The sale was, as previously stated, a sale on July 28, 1936, of the bankrupt's then existing stock of wallpaper and paint. That stock was disposed of by the corporation long prior to the filing

of the petition in bankruptcy. Appellee never got possession of that stock or any part of it. The Referee's order dealt, not with that stock, but with other property of the corporation, property which appellee took possession of and sold, and with the proceeds thereof in Appellee's hands. That property was not purchased from the bankrupt. The bankrupt never owned it, never had possession of it, never sold it or attempted to sell it. Therefore, the fact, if it be a fact, that the sale on July 28, 1936, of the bankrupt's then existing stock of wallpaper and paint was made with intent to delay or defraud the bankrupt's creditors is, for present purposes, immaterial."

The law in California, however, is different. If the fraudulent transferee has disposed of the fraudulently transferred property the trustee or the persons injured thereby may recover the value thereof. Bankruptcy Act, § 70-e, 11 USCA, § 110-e.)

Brainard v. Cohn, 8 Fed. (2d) 13.

In the early case of *Swinford v. Rogers,* 23 Cal. 234, the Supreme Court said:

"The appellants also contend that the Court erred in rendering a personal money judgment against the fraudulent vendees, Smith & Rogers, and that the allegations of the complaint are not sufficient to sustain such a judgment. As a general rule, a Court of Equity declares the fraudulent conveyance void, and directs that the property be sold for the satisfaction of the creditors' debt; but where a fraudulent vendee sells the property, or converts the same to his own use, that kind of relief is rendered impracticable, and he is clearly liable to account for the value thereof, and pay the same to the creditors of

the vendor. (Ludlow v. Kidd, 4 Ham. 244; Sparrow v. Chester, 19 Me. 79; Jones v. Henry, 3 Littell, 428.)

In *Cooper v. Nolan,* 138 Cal. 248, the Supreme Court of California, in modifying a decree providing for imprisonment of a fraudulent transferee until he should have paid a money judgment in the sum of $4,933.25 collected from fraudulently transferred property, approved the judgment for the value, in this terse language:

> "The decree to that extent is justified by the nature of the action. If the defendant should fail to comply with the order of the court to turn over to the assignee in insolvency what he received from the debtor, W. S. Nolan, or the proceeds thereof now in his hands, the court might then take steps to enforce a compliance with its decree; but in such case the defendant should first be cited to show cause why he does not comply with the order of the court, and be given an opportunity to be heard."

The Court merely relieved the defendant in that case from summary imprisonment under the money judgment rendered.

In the *Downey* case the trustee in his petition seeking to avoid the transfer by Downey of over $14,000 worth of merchandise to his family corporation with the intent and purpose on his part to hinder, delay, or defraud his creditors, prayed [Tr. p. 86]:

> "That an order be entered decreeing the organization of the Downey Wallpaper & Paint Co., and all of the transactions hereinbefore set forth, to be fraudulent and void and of no force and effect as against the trustee in bankruptcy herein, and decreeing said Downey Wallpaper & Paint Co., to be the

alter ego of said bankrupt, Wilbur J. Downey, and marshalling all of its assets and administering them in this bankrupt estate for the benefit of the creditors of said bankrupt, *and for such other and further relief as the Court may deem just and equitable in the premises.*" (Italics ours.)

At the hearing thereon it developed that the fraudulent transferee, although it may have disposed of the identical articles fraudulently transferred by Downey to it in July, 1936, it still had on hand a substantial stock of merchandise which was subject to being levied upon and sold under execution. This property or stock in trade was in the actual, physical possession of the trustee and subject to the summary jurisdiction of the Referee. Instead of going through the circuitous procedure of having the Referee render an order finding that Downey had fraudulently transferred $14,000 or more of his stock to the Downey Wallpaper & Paint Co., three years before and that the identical articles of merchandise so transferred had been sold and disposed of and were no longer in his possession and that the trustee would be entitled to a money judgment in the sum of $14,194.72 and under that judgment would be entitled to a writ of execution which a Referee in Bankruptcy is powerless to issue and then requiring the trustee to go on to either the law side of the United States District Court or to the Superior Court of the State of California, in and for the County of Los Angeles and pleading *res adjudicata,* asking for a money judgment and execution and levying upon the stock in trade which was even then in the actual possession of the bankruptcy court, the Referee simply exercised his equitable powers, and it not being asserted that the merchandise in the trustee's possession was in excess of the

sum of $14,194.72, the Referee simply marshalled those assets in the bankrupt estate, decreed the trustee to be the owner of them and ordered them sold.

Let us suppose, on the other hand, that the circuitous procedure had been followed and the money judgment for the value obtained by the trustee and the property levied upon under writ of execution. Could the Imperial Paper & Color Corporation, a contract creditor pure and simple, of the fraudulent transferee, have come into any court in California and asserted an equitable lien or a right to be paid in full before the sheriff sold the property at execution sale? Certainly not. And we do not believe that because the Referee exercised his equitable powers in the interests of expedition and to avoid circuity of action, this claimant at whose suggestion the fraud originated, should be placed in a position even higher than it would have been placed had it filed an involuntary petition in bankruptcy against the Dowfley Wallpaper & Paint Co., within four months after the entry of the order of Referee Dickson on April 7, 1939, decreeing the transfer to have been actually fraudulent.

Neither do we know of any type of proceeding which could have been instituted in any court by the Imperial people after a decree as between the actual parties to the fraud had become final, wherein it, as a creditor of the fraudulent transferee, could collaterally attack that decree. In fact, in the case at bar no attempt was made to do so. The Imperial people, recognizing said order and in nowise contending that it was obtained by fraud or that the order was improper, in its petition seeking priority, sets out in paragraph III [Tr. p. 15];

> "That the above entitled bankrupt estate, and the trustee thereof, claims and asserts that the Downey

> Wallpaper & Paint Co., a corporation, is and was the *alter ego* of the above named bankrupt, and that the trustee herein has procured an order of court to that effect."

Had the Imperial Paper alleged in its petition that said order was fraudulently obtained or was improper, then we might have gone ahead and tried the entire fraudulent conveyance proceeding over again, but the order having been recognized by the Imperial Paper and Color Corporation, we merely went forward and proved Imperial's connection with the fraud theretofore established.

Conclusion.

We respectfully submit that through an erroneous conception of facts the Circuit Court of Appeals for the Ninth Circuit fell into serious error, error which, if permitted to stand, will not only work a gross injustice in the instant case, but will establish a dangerous precedent of law.

It is clear that this is a case in many ways similar to that of *Buffum v. Barceloux Co.*, 289 U. S. 227, in which this court granted certiorari and later reversed the judgment of the Circuit Court. The bankrupt Downey had involved himself to the extent of $108,000 with the Standard Coated Products Corporation, and it was giving him a chance to slowly work out. He apparently decided to put in the line of a competitor, the Imperial Paper and Color Corporation, and it was desirous of selling him. The Imperial people fearing to do so, however, by reason of the constant menace of Downey's huge indebtedness to the Standard Coated Products Corporation, through its president, suggested to him that he either "chisel" the Stand-

ard Coated Products claim to what the Imperial regarded as a decent compromise figure, or go through bankruptcy (in which event the $14,000 stock would have been available to his creditor, the Standard Coated Products Corporation), or form a corporation. This was the first time the latter idea had entered into Downey's head. The Standard Coated Products refused to accede to any of Downey's propositions, so Downey came back to Los Angeles and organized a corporation entirely within his family. To quote the language of Justice Cardozo in *Buffum v. Barceloux Co., supra:*

> "The business was a family affair, and strangers were not welcome within the family preserve. A time arrived when the unwelcome stranger seemed likely to break in. The family combined to maintain its solidarity and keep the intruder out."

Downey then proceeded to "sell" practically his entire stock in trade to his family corporation, it amounting to in excess of $14,000, after filing a bulk sales notice which falsely stated that he was transferring only $7500.00 worth of his stock. The sale was made entirely on credit, and by means of gratuitous extensions of payment, final settlement of this amount was delayed from the middle of 1936 until the middle of 1939, when Downey satisfied the note in full, in exchange for the capital stock, which he immediately transferred to his wife and son.

It is evident that the Standard people were becoming restive at the time of the issuance of this stock and Downey decided to entangle matters still further by getting rid of the note first and then the stock, in order that the Standard people could not attach the balance due in the hands of his family corporation.

The Imperial Paper and Color Corporation Recognized the Existence and Finality of the Order of Referee Dickson of April 7, 1939, Quieting Title to the Fraudulently Concealed Assets in Favor of the Trustee, and Affirmatively Pleaded It, and It Was Unnecessary to Retry the Issue of Downey's Fraudulent Transfer.

The petition filed by the Imperial Paper and Color Corporation for an order granting either priority or an equitable lien affirmatively alleged in paragraph III thereof "that the above entitled bankrupt estate and the trustee thereof claims and asserts that Downey Wallpaper and Paint Co., a corporation, is and was the *alter ego* of the above named bankrupt, and that the trustee herein has procured an order of court to that effect, and that said trustee herein has taken possession of the property and assets of the Downey Wallpaper and Paint Co., and has sold and disposed of the same and claims a right to distribute the assets."

The trustee did not dispute that fact, and therefore, a retrial of the issue of Downey's fraudulent intent was unnecessary. All that was necessary for the trustee to do was to show a connection of the petitioner, Imperial Paper and Color Corporation with Downey's fraud, which both the Referee and District Court were satisfied we had done. The action of the president of the Imperial Paper and Color Corporation in inciting Downey to the formation of this dummy corporation and transferring his stock in trade to it in violation of the rights of the Standard Coated Products Corporation, definitely placed the Imperial Paper and Color Corporation *in pari delictu* with Downey and his dummy corporation.

As a result of their scheme the Standard Coated Products Corporation was hindered, delayed and defrauded in the collection of its indebtedness from Downey. Instead of having extended credit to the Downey Wallpaper & Paint Co., "in good faith," as alleged by it [Tr. p. 15], the Imperial Paper and Color Corporation had extended the credit in bad faith and as a means of assisting Downey to defraud a creditor. This was expressly found by the Referee who saw the witnesses and had the opportunity to judge their credibility first hand. [See Referee's Order Disallowing Imperial Paper and Color Corporation's claim as a prior claim, Tr. p. 34. Also see Referee's Certificate on Review, Tr. p. 24.] This finding was confirmed by the District Judge and was reversed by the Circuit Court of Appeals, we believe, due to a misconception of the facts.

To permit this decision to stand simply means that hereafter a trustee in bankruptcy, seeking a money judgment against a person who has obtained a fraudulent transfer from a bankrupt under the provisions of Section 67-e of the Bankruptcy Act, or Section 70-e and who had disposed of property *in specie*, before the action was commenced against him, would be obliged, after he recovered his judgemnt, to first pay off all the creditors of the fraudulent transferee before he could levy on his property. This would be especially embarrassing in the case of a merchant who had obtained a fraudulent transfer from another merchant who had gone bankrupt.

Prior to the holding of the United States Circuit Court of Appeals for the Ninth Circuit in the case at bar, the trustee could bring suit against a fraudulent transferee and recover a money judgment against him for the value

of the property so transferred. (Bankruptcy Act, Sections 67-e and 70-e.) He could then procure the levy of a writ of execution on the defendant's stock in trade and sell it. Now, if this decision stands, it would seem that the trustee would first be obliged to hunt up all the fraudulent transferee's creditors, mercantile or otherwise, whose goods had been sold to the fraudulent transferee on open account, and pay them up in full. Then if there was anything left he could levy on it. If he did not, then this decision creates an entirely new list of prior creditors, because after the seizing and selling of the fraudulent transferee's stock in trade under execution sale, his creditors would have a right to come in and file prior claims against the bankrupt estate and have them allowed in full.

We do not believe that this court will permit a new class of priorities not provided for in the Bankruptcy Act, and especially in a case where the person or corporation seeking the priority was the instigator of the scheme to defraud.

We respectfully submit that a writ of certiorari should be granted and the judgment of the Circuit Court of Appeals reversed.

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